BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

DOCKET NO. 2011-317-WS - ORDER NO. 2012-235

MAY 23, 2012

IN RE:	Application of Kiawah Island Utility, Incorporated for Adjustment of Rates and Charges	)))	ORDER DENYING PETITION

I. INTRODUCTION

This matter comes before the Public Service Commission of South Carolina ("the Commission") on the Petition for Rehearing or Reconsideration of Order No. 2012-98, filed by the Kiawah Island Property Owners Group ("KPOG"). Order No. 2012-98 granted an increase in rates and charges for water and wastewater services to Kiawah Island Utility, Inc. ("KIU"). We have considered each of the points raised by KPOG, and we deny the Petition.

II. DOWN ISLAND AND SEWER TREATMENT PARCELS

First, KPOG asserts that this Commission should disallow any expenses associated with the purchase of the land alone for the Down Island Storage Facility in 2008 and the Sewer Treatment Parcel in 2009 on the grounds that KIU did not separately obtain Commission approval for each sale under Commission regulations. KPOG relies on the Commission's disallowance of expenses associated with the purchase of the Cougar Island parcel in 2010 for Aquifer Storage and Recovery ("ASR"). KPOG's reliance on the Commission's enforcement of its regulations with regard to the Cougar Island parcel is misplaced.

The circumstances surrounding the purchases of the land for the Down Island Storage Tract and Sewage Treatment Tract differ significantly from the Cougar Island ASR site. Unlike the Cougar Island parcel which was purchased outright in 2010 without prior Commission approval, both the Down Island and Sewage Treatment parcels were previously leased by KIU's parent, KRA, to KIU to allow KIU to install facilities necessary for the operation of the utility in the mid-1990s. (Tr. pp. 173-174). These two leases and the expenses associated with them were first put under scrutiny as part of KIU's 1996 rate application. Order No. 97-4, p. 16; Order No. 97-151, p. 9. This Commission admonished KIU for its failure to obtain pre-approval of the two leases; however, we allowed the rental expenses, since KIU demonstrated the amount, based on an independent appraisal, was reasonable and the land was used and useful to the utility's operations. We reaffirmed and further explained our rationale regarding our allowance of these rental expenses in a later Order in the case. Order No. 2000-713, pp. 15-17. Further, the South Carolina Supreme Court affirmed our decisions in this area. See Kiawah Property Owners Group v. The Public Service Commission of South Carolina, et.al., 230 P.U.R. 4th 359, 357 S.C. 232, 593 S.E. 2d 148 (2004).

KIU's more recent *purchase* of these two previously leased parcels (the Down Island Storage Facility and the Sewer Treatment Parcel) accomplished what KPOG argued in the prior rate proceeding should have occurred. KPOG previously based its opposition to the lease expenses on its argument that the Utility should buy, rather than lease, land on which it constructed facilities. As explained by witness Heyboer in this proceeding, KIU did not have the funds on hand or the ability to borrow in the mid-1990s

and was required to lease instead. (Tr. pp. 160-161). The two leases were amended to include an option to purchase for the market value of the land alone. (Tr. pp. 173-174). The Lease Amendment required that the purchase price be determined by independent appraisals. (Tr. pp. 159-162, 173-174). When the options were exercised in 2008 and 2009, the purchase price for these two sales was determined by separate independent appraisals of the value of the land alone. Id. With respect to KPOG's challenge as to the timing of the purchases, Heyboer testified the timing was favorable to KIU since the real estate values were down in 2008 and 2009. (Tr. pp. 183-184). The record is undisputed that located on the two tracts is important plant in service, used and useful for the operation of the utility. We believe that these facts fully support our findings and distinguish the acquisition of these two previously leased parcels from KIU's outright 2010 purchase of the Cougar Island site for ASR, which was done without any prior guidance from the Commission in regard to whether the property was used and useful for the operation of the utility.

S.C. Code Ann. Regs. 103-541 and 103-743 do not specify that contracts entered into without prior approval of the Commission are *per se* invalid regardless of their reasonableness or the contracting utility's essential need for the services or property subject to the contract. (See Kiawah Property Owners Group case). The two leases that were amended to grant an option to purchase had previously been reviewed in detail and, as stated, the expenses associated with them were allowed in the test year in all KIU rate applications after the entry of the leases.

As stated by this Commission in the prior Order, the guiding determination in reviewing transactions between a utility and an affiliate is whether the utility established the reasonableness and propriety of the services rendered or property purchased as well as the reasonableness of their cost. Order, p. 21. KIU met this burden of proof as to the purchase of these two parcels through the testimony of witnesses Heyboer, Dennis, and Guastella. KPOG did not offer any evidence that the purchase price of the land was excessive or unreasonable. Therefore, expenses related to the *purchase* of the two properties were allowable, consistent with the Supreme Court's previous ruling regarding the *lease* of those same properties in the Kiawah Property Owners Group case.

KPOG is incorrect in arguing there is no proof that the purchase price for each of the two parcels was determined by independent appraisal. KPOG makes this contention because KIU did not introduce the two appraisals as exhibits. The evidence in this case consists of the admitted exhibits *and the testimony*. Witness Heyboer's testimony that the purchase price of the land for each of the two parcels that were under lease was determined by independent appraisals obtained by KIU is acceptable evidence of the method used to determine the purchase price.

This Commission's disallowance of the Cougar Island property expenses must be differentiated, since, unlike the circumstances with the Down Island and Sewage Treatment parcels, the Commission had never issued a ruling before on the propriety of the expenses for the Cougar Island property, and KIU failed to submit the contract for purchase of the property to this Commission for review in advance, pursuant to S.C. Code Ann. Regs. 103-743 (Supp. 2011). We once again admonish KIU to follow this

regulation in the future, or risk non-approval of property expenses. However, the disallowance of the Cougar Island property expenses is distinguishable from the purchase of the Down Island and Sewage Treatment parcels. We discern no error.

III. BANK TRANSACTIONS

KPOG also questions various loan transactions between KIU and RBC Bank. Witness Heyboer testified at length to KIU's credit facility with RBC Bank. KIU's previous lender was Bank of America. Heyboer testified that KIU refinanced with RBC to pay off its Bank of America notes and consolidate its debt. (Tr. pp.193-194). KPOG argues that KIU entered "onerous contractual agreements and loan provisions with RBC." Petition, p. 6. KPOG apparently bases its contention that the loan arrangement was "onerous" on terms of an interest swap agreement entered to protect KIU against rising interest rates and the standard provisions granting a security interest in the stock and assets of KIU to RBC.

Heyboer testified that KIU entered the interest swap contract to place a ceiling or cap on the potential increase in the variable interest rate of the RBC loan. (Tr. pp. 186-187, 189). The swap "in essence, turned the variable rate loan into a fixed rate loan at 5.45 per cent." (Tr. p. 186). This testimony establishes the reasonable purpose for entering the interest rate swap agreement. Heyboer also testified that the interest rate swap terminated without any payment by KIU to RBC. (Tr. pp. 189, 208-209). There were no expenses in the test year associated with the interest rate swap agreement. KPOG's argument is not supported by credible, competent proof that the transaction was unreasonable or harmed KIU in some manner, which we find it did not.

Turning to the terms of the loan, Heyboer testified that the terms were standard for loans of this nature. (Tr. pp. 190). The loan documents themselves (Stipulated Exhibit 3, Tabs 17, 18, and 19) show that they are standard forms used by conventional commercial lenders. While KPOG takes issue with these standard terms, KPOG put forward no proof that these terms were anything other than the standard form provisions or that this loan to pay off Bank of America could have been obtained and closed on more favorable terms.

As pointed out in previous filings in this case, KPOG misunderstands the cross-default provision under the RBC loan documents. The form loan document specifies that KIU's default also constitutes a default as to any loans to its subsidiaries. (Exhibit 3, Tab 14, p. 23, 13(K)). KIU has no subsidiary. Kiawah Resort Associates, LP ("KRA"), the parent of KIU, is not a party to the loan agreement and is not a subsidiary of KIU. A hypothetical default by KRA on its separate loan obligations with other lenders has no effect on KIU.

KPOG mistakenly suggests that KIU owes RBC $15 million. Petition, p. 8. As witness Heyboer testified, the balance of the loan is approximately $8.3 million. It is common practice to have a mortgage in a higher amount that would allow future advances. (Tr. p. 158).

In conclusion, the evidence does not demonstrate that the loan terms between KIU and RBC are "oppressive and onerous." Petition, p. 8. The proof from witness Heyboer is that these were standard terms imposed by the lender, RBC, for a favorable loan that consolidated KIU's bank debt and took out Bank of America. (Tr. pp. 193-194). As

Heyboer testified, very little of the balance of the amount drawn on the loan related to KIU's purchases in 2008 and 2009. (Tr. p. 161).

Moreover, as stated by this Commission in our original Order, the Commission does not have authority and jurisdiction to alter the loan documents or enter relief against RBC, which is not a party to this proceeding. Kiawah Property Owners Group v. Public Service Commission of South Carolina, Id. Finally, as stated by our Supreme Court in deciding a previous appeal by KPOG that attacked the terms of the prior loans with Bank of America, "the argument that the cross-collateralized loan agreement will harm rate payers in the future does not present a justiciable controversy." 597 S.E.2d 149. Again in this case, the possible consequences from RBC's exercise of its rights under the loan documents in the event of a default by KIU is entirely speculative and does not present a justiciable issue for determination by the Commission.

KPOG repeatedly refers to "seven different applications since 2002, even as late as 2010, for pass through rate adjustments." It should be noted that these were for the express purpose of passing through increases in the cost of wholesale water imposed by KIU's wholesale supplier. KIU made no profit on these increases, but was simply passing through the increased wholesale cost of water to the ratepayers. This is of no significance to the issues before this Commission in this case.

IV. 1997 AGREEMENT

KPOG raises the spectre of an agreement made between KIU and KRA in 1997. In 1997 KIU and KRA entered a Utility Service Agreement ("USA") that set forth reciprocal obligations between the two entities. This USA replaced a previous such

agreement entered between KIU and KRA in 1994. KIU did not seek approval in this rate proceeding of any expense associated with the 1997 USA since, among other things, the 1997 USA did not impose any expenses on KIU.

Nonetheless, KPOG argues that the utility was prejudiced because the 1997 USA stated that KRA would sell the property to KIU at fair market value. As attested by witness Guastella (Tr. p. 244) and stated by the Commission in the Order (Order, p. 17), there is no regulation or requirement that the parent of a public utility donate property or sell property at less than fair market value. KPOG appears to argue that the sales price should be governed by the 1994 Utility Service Agreement that specified that property would be sold by KRA to KIU at 50% of fair market value. However, that agreement was terminated.

V. AUDITED KIU FINANCIAL STATEMENTS

KPOG further asserts that the audited financial statements of KIU contained a number of important financial issues directly related to the proposed increase which were not addressed in Order No. 2012-98.

In its Petition, KPOG randomly selects a few items from KIU's audited financial statements suggesting that they are suspicious or irregular. KPOG failed to put forward competent, credible testimony that these entries are incorrect or that they affect the test year revenues and expenses allowed by the Commission.

KIU files annual financial reports with the Commission. These annual reports are tied to the audited financial statements of KIU. ORS fully reviewed those reports and the back-up documentation during its financial audit of KIU. KPOG's attack on ORS is

unwarranted. ORS closely scrutinized all expenses of KIU associated with the test year and made adjustments that KIU accepted for purposes of reducing the matters at issue in this proceeding.

Two corrections to KPOG's contentions are in order. There is nothing "interesting and unusual," as intimated by KPOG, about KIU's changing auditing firms in the last ten years. (Petition, p. 13). The names changed but the auditors did not. The accounting firm of Finch Hamilton (first firm) merged with the accounting firm of Webster Rogers (second firm).

Second, KPOG singles out a footnote to the 2010 audited financials that land in the amount of $1,264,450 was exchanged for an addition to a note payable. (Petition, P. 13; Hearing Exh. 3, Tab 10, p. 6). This note payable was not a note to KRA but rather an addition to the amount under the note payable to RBC.

The focus in reviewing a rate application is the revenues and expenses in the test year. The audited financial statements did not change either the revenues or expenses for the test year that were ultimately allowed by the Commission. The Commission fully considered the testimony of the witnesses and other evidence in making its findings concerning adjustments to the test year revenues and expenses that are amply supported by the evidence.

VI. RATE OF RETURN VERSUS OPERATING MARGIN

KPOG insists that the proper approach to rate setting in the present case was through rate of return on equity. As stated in our prior Order, we found that the operating margin approach was the more suitable approach to KIU's application and that a

reasonable and fair operating margin was 13.75%. Further, the Commission fully weighed the testimony as to an appropriate operating margin. This Commission was entitled to determine what weight should be given to the testimony of the witnesses, including the experts. Exercising our discretion to weigh the evidence, the Commission based the operating margin determination on the testimony of the ORS witnesses, as well as witness John F. Guastella. These witnesses' testimony fully supports this Commission's findings and conclusions as to a reasonable operating margin. KPOG witness Rogers' testimony was given full consideration by this Commission in our deliberations, but the testimony of the ORS witnesses and company witness John Guastella was more credible, in our opinion.

VII. CUSTOMER TESTIMONY

KPOG argues that the sentiments against a rate increase expressed by customers who spoke at the night hearing or submitted letters should control the outcome of this proceeding. These letters and comments were mostly general in nature in regard to opposition to the proposed rate increase.

To the extent the letters and comments were specific as to the amount of increase requested, several incorrectly asserted that KIU was seeking a 39% increase in rates. KIU withdrew its request for the phase 2 increase to water rates to pay for the secondary line. The 39% increase to water rates would have occurred only if the secondary line was constructed and the rates approved thereafter. The percentage increase to water rates is approximately half of that stated by the opponents. Many of the comments featured by KPOG in its Petition asserted that the ratepayers should not bear the cost of the second

water line if its purpose was to serve new development. Even though witness Dennis testified that KIU had adequate capacity to serve build out without the second supply line, the issue was rendered irrelevant when KIU withdrew the portion of its Application seeking the phase 2 increase.

None of the comments were directed to the revenues and expenses in the test year. Thus, the comments have little pertinence to the Commission's determinations regarding those issues in the Order, which are fully supported by the record.

VIII. DENIAL OF MOTION TO COMPEL

KPOG also asserts that the Hearing Officer's denial of its Motion to Compel should be reversed, which we declined to do in our previous Order in this Docket. There are several valid legal grounds for upholding the Hearing Officer's denial of KPOG's Motion to Compel. KPOG's interrogatories violated the regulation governing pre-hearing interrogatories that requires service more than ten (10) days before the scheduled hearing. Additionally, contrary to KPOG's argument, the evidentiary record did not remain open after the final hearing, except for the one or two items requested by the Commission. As for KPOG's argument of judicial notice, 26 S.C. Code Ann. Regs. 103-846(C) controls over the South Carolina Rules of Evidence in these regulatory proceedings. As found by the Hearing Officer, KPOG did not meet the requirements of this regulation for taking notice of judicially cognizable facts. Finally, as noted in Plaintiff's Opposition to KPOG's Motion to Overrule the Hearing Officer, two of the three records from the RMC Office described in the Motion to Compel do not involve the properties that were purchased by KIU from KRA.

For all of the reasons stated above, the KPOG Petition for Rehearing and Reconsideration is denied.

This Order shall remain in full force and effect until further order of the Commission.

BY ORDER OF THE COMMISSION:

John E. Howard, Chairman

ATTEST:

David A. Wright, Vice Chairman
(SEAL)